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Advising Compliance in Financial Firms: A New Mission for the Legal Academy

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ARTICLES

ADVISING COMPLIANCE IN FINANCIAL FIRMS: A NEW MISSION FOR THE LEGAL ACADEMY

*James A. Fanto**

This introduction to the symposium issue provides background on the subject of compliance in financial firms, whose task is to ensure that a broker-dealer and its employees comply with applicable laws and regulations. It explains the tasks of compliance in financial firms and discusses its origins, particularly in the statutory and regulatory obligation of supervision that is placed upon financial firms and their managers. It then looks at the reasons for the growth in importance of compliance in recent years, as well as the likely continued significance of this firm function. It particularly emphasizes how the recent financial reform legislation enhanced the role of compliance and diffused it into previously unregulated financial firms. It next offers several reasons why legal scholars have not devoted much attention to financial firm compliance and also discusses why compliance is attracting more scholarly attention, partly because law graduates are increasingly entering this field. It concludes by offering a few thoughts on how the legal academy can help compliance become more successful in its mission, with a reference to contributions of the professors made during the symposium and to useful work in managerial studies on how to build effective compliance programs.

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INTRODUCTION

There were several motivations for our symposium on financial firm compliance, entitled “The Growth and Importance of Compliance in Financial Firms: Meaning and Implications.”¹ First, since the role of compliance officers has become important and grown in prestige in

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1. This symposium took place on February 8, 2013, at Brooklyn Law School.

financial firms, it was interesting and useful to explore the reasons for this phenomenon in an academic setting. Second, the growth in importance of compliance has occurred without attracting much attention from legal scholars. Devoting a symposium to the subject helps partly to remedy this situation. Third, the symposium was also worthwhile to our students because they appear to be entering into this field in increasing numbers, for, in an otherwise gloomy job market, compliance represents a potential area of job growth. Fourth, alumni of our school have important positions in the compliance field and one of the purposes of our Center for the Study of Business Law & Regulation is to connect our students to alumni in business law practice. Accordingly, a symposium on compliance brought several of our alumni working in compliance to the school for this purpose.²

For the symposium we invited legal scholars who follow developments in finance closely and who are knowledgeable about broker-dealers and investment advisers. To a person, they recognized the importance of the topic and were happy to participate in the symposium. Moreover, as noted above, the symposium included practitioners in compliance. The design of the symposium was to have presentations by professors on compliance-related issues, with compliance practitioners commenting on their talks, often to inject a real-world perspective into the discussion. The Articles presented in this issue represent the fruit of that exchange but only imperfectly capture the lively debates that occurred during the symposium.³

In this Introduction to the symposium issue, I shall provide background on the subject of compliance. Part I will explain the nature of compliance in financial firms and discuss its origins, particularly in the statutory and regulatory obligation of supervision that is placed upon financial firms and their managers. Part II will look at the reasons for the growth in importance of compliance in recent years, as well as the likely continued significance of this firm function. It will particularly emphasize how the recent financial reform legislation enhanced the role of compliance. Part III will offer several reasons why legal scholars have not devoted much attention to financial firm compliance. This Part will also discuss why compliance is attracting more scholarly attention, partly because law graduates are increasingly entering this field. The Article concludes by offering a few thoughts on how the legal academy can help compliance become more successful in its mission, with a reference to contributions of the professors made during the symposium.

2. Commentators at the symposium included Ira Goldberg (class of '96), a managing director of JP Morgan Securities; Jonathan Gottlieb (class of '92), a managing director and senior counsel at RBS Securities; Jane A. Kanter (class of '73), a partner at Dechert LLP; and Andrew S. Margolin (class of '90), managing director and associate general counsel of Bank of America Merrill Lynch.

3. The symposium was a success even though it took place on a Friday when a blizzard rolled into the New York area!

I. COMPLIANCE, ITS ORIGINS AND PRESENT STATE

It is first useful to identify the compliance function in a firm.⁴ To put things simply, the basic job of compliance is to ensure that a broker-dealer and its employees comply with applicable laws and regulations.⁵ The relevant laws and regulations are mainly the federal securities laws and regulations of the U.S. Securities and Exchange Commission (the SEC), but they also include the rules and professional standards of self-regulatory organizations (SROs),⁶ as well as the diverse kinds of laws that apply to financial firms today (e.g., anti-money laundering rules).⁷ Compliance, which is composed of compliance officers, occupies a middle position between the business of the broker-dealer, on the one hand, and regulators and SRO officials, on the other. Compliance officers do not engage in the firm's securities business, but are part of one of its oversight or control functions, like internal accounting, internal control, and legal.⁸ Indeed, in its early days compliance was a task of or a subdivision within the legal department.⁹ As a result of this oversight function, investment bankers, brokers, and other business employees of broker-dealers traditionally looked down upon and even resented compliance officers as being an unproductive part of, and even an impediment to, the investment banking

4. The discussion will focus on compliance only in broker-dealers, who are regulated under the Securities Exchange Act of 1934 (the Exchange Act), 15 U.S.C. §§ 78a–78pp (2012), since compliance is well developed in broker-dealers. A broker-dealer is a firm, registered as such under the Exchange Act, *id.* § 78o, that, as is typical, conducts both the functions of a “broker,” which acts as an agent for others in securities transactions, *id.* § 78c(a)(4), and a “dealer,” which generally is in the business of making markets in securities, *id.* § 78c(a)(5).

5. See SEC. IND. ASS'N, LEGAL & COMPLIANCE DIV., WHITE PAPER ON THE ROLE OF COMPLIANCE 2 (2005) [hereinafter SIA, WHITE PAPER ON THE ROLE OF COMPLIANCE], available at http://www.sifma.org/uploadedfiles/societies/sifma_compliance_and_legal_society/role_of_compliance_white_paper%20%282%29.pdf.

6. SROs are securities organizations where the members, rather than an outside body, primarily regulate themselves. See 1 NORMAN S. POSER & JAMES A. FANTO, BROKER-DEALER LAW AND REGULATION § 4-3 to 4-4 (4th ed. 2007 & Supp. 2013). The Securities Exchange Act of 1934 is based upon a self-regulatory model, where SROs do much of the regulation subject to the oversight of the SEC. See *id.* § 4-3. The Financial Industry Regulatory Authority (FINRA), which is a union of the former self-regulatory arms of the National Association of Securities Dealers (the NASD) and the New York Stock Exchange (the NYSE), is the main SRO for broker-dealers and is a registered securities association under section 15A of the Exchange Act, 15 U.S.C. § 78o-3. At the symposium, our opening speaker was Grace B. Vogel, FINRA's Executive Vice President of Member Regulation.

7. See SIA, WHITE PAPER ON THE ROLE OF COMPLIANCE, *supra* note 5, at 5.

8. It is true that, in smaller firms, a broker, trader, or supervisor of the firm may also be a compliance officer because the firm is not large enough to have a separate compliance department or group. Or, in a small firm, the only compliance officer may be engaged in multiple control functions (e.g., be both the main privacy officer and chief anti-money laundering officer).

9. See O. Ray Vass, *The Compliance Officer in Today's Regulatory Environment*, BROKER-DEALER INSTITUTE, at 49 (PLI Corp. Law & Practice, Course Handbook Ser. No. 579, 1987) (discussing early configuration of compliance in firms).

and securities business.¹⁰ A compliance officer helps ensure that the firm and its employees follow the laws and regulations, but he or she does not have the status and independence of a regulator or an SRO official, although he or she may have spent part of the career with the SEC or FINRA and this experience may have played a role in his or her obtaining the compliance officer position.¹¹ Yet, as discussed below, regulators work closely with compliance officers and may consider them their eyes and ears in a firm.¹²

To a great extent, compliance in broker-dealers grew out of broker-dealers' supervisory obligations over their personnel under the federal securities laws.¹³ To show this demands a brief review of several key statutory provisions for broker-dealers. Section 15(b)(4)(D) of the Exchange Act empowers the SEC to discipline a broker-dealer for, among other things, the willful violation of, or the inability to comply with, the federal securities laws or their regulations by the broker-dealer itself or by any person "associated with" the broker-dealer.¹⁴ If an employee of a broker-dealer willfully violated the securities laws or regulations, the broker-dealer would be subject to SEC discipline under this statutory provision, which could include suspension of its registration for up to twelve months or the "death sentence" of revocation of registration.¹⁵ This

10. See Todd L. Spillane, *So You Are a Compliance Officer, Now What?* PRAC. COMPLIANCE & RISK MGMT. FOR THE SEC. INDUS., Nov.–Dec. 2010, at 1, 2–3 (describing the delicate relationship between compliance officers and business people).

11. See PROJECT ON GOV'T OVERSIGHT, DANGEROUS LIAISONS: REVOLVING DOOR AT SEC CREATES RISK OF REGULATORY CAPTURE 2 (2013), available at <http://pogoarchives.org/ebooks/20130211-dangerous-liaisons-sec-revolving-door.pdf> ("The movement of people to and from the financial industry is a key feature of the SEC, and it has the potential to influence the agency's culture and values."). The purpose of this report is to highlight the danger of regulatory capture, particularly as it affects decisions by regulators to pursue lawsuits against financial firms. However, it indicates the interest of financial firms in hiring former regulators in control functions. Many senior compliance officers have spent time with the SEC or FINRA. For example, Jonathan Gottlieb, who was one of the alumni compliance officers present at our symposium, formerly worked for the SEC's Division of Enforcement.

12. See *infra* text accompanying note 44.

13. The focus here is only on the brokerage industry-specific origins of compliance within broker-dealers. See generally Miriam Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949, 958–75 & nn.48–162 (2009) (discussing origins of corporate compliance and referencing the significant contributions to the scholarly literature about them). Professor Baer, who is a specialist on the interrelationship between compliance and enforcement, among other things, was a commentator at our symposium.

14. See 15 U.S.C. § 78o(b)(4)(D) (2012). "Associated person" is itself defined in section 3(a)(18) of the Exchange Act to include "any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer." *Id.* § 78c(a)(18). This definition sweeps within it all those who engage in the securities business in a broker-dealer, as well as controlling persons, but an exception (not quoted above) excludes clerical and ministerial employees, among others. *Id.*

15. See generally Task Force on Broker-Dealer Supervision & Compliance of the Comm. on Fed. Regulation of Sec., *Broker-Dealer Supervision of Registered Representatives and Branch*

statutory provision thus gives a broker-dealer an incentive to supervise its employees to ensure that they comply with applicable laws and regulations so that it can, in fact, stay in business.

Section 15(b)(4)(D) was a rough and imperfect instrument for the SEC to ensure legal compliance by broker-dealers and their employees because it allows the SEC to discipline only the firm, not the violating employee, and it does not provide for discipline of firm supervisors.¹⁶ The Securities Acts Amendments of 1964 enhanced supervision, and gave a major impetus to compliance, by adding sections 15(b)(4)(E) and 15(b)(6).¹⁷ Under section 15(b)(4)(E), a broker-dealer is subject to sanctions if, among other things, it, or an associated person, willfully aided or abetted a federal securities law or rule violation or “failed reasonably to supervise, with a view to preventing” the violation, the person who committed the violation.¹⁸ This amendment made the broker-dealer explicitly liable for its own, and its associated persons’, supervisory violations. Furthermore, section 15(b)(6) empowers the SEC to discipline an associated person who, among other things, willfully aids and abets a violation of the federal securities laws or who commits a supervisory violation.¹⁹ Under this provision the SEC can discipline branch managers and other supervisors in a broker-dealer for their failure to supervise employees under their authority. These explicit supervisory obligations on firms and firm supervisors created an enhanced need for a broker-dealer to have people (i.e., compliance officers) to tell the supervisors and the other employees what compliance with the laws and regulations entails so that the employees could conduct themselves in a lawful manner and the supervisors could properly conduct their supervision and avoid supervisory liability.

Even more importantly for the growth of compliance, section 15(b)(4)(E) provides both the firm—and, through section 15(b)(6), firm supervisors—with defenses to a supervisory violation charge. It states that “no person shall be deemed to have failed reasonably to supervise any other person” if, first, there were “established procedures, and a system for applying” them, “which would reasonably be expected to prevent and detect, insofar as practicable,” any securities law violations by the supervised person.²⁰ It further stipulates that the supervisor has “reasonably” to discharge the duties under the procedures and system

Office Operations, 44 BUS. LAW. 1361, 1363–64 (1989) (discussing the SEC’s early legal theories to enforce supervisory liability upon broker-dealers, which included the standard tort doctrine of respondeat superior).

16. See POSER & FANTO, *supra* note 6, § 9-5 to 9-6.

17. Securities Acts Amendments of 1964, Pub. L. No. 88-467, sec. 6(b), § 15(b)(4)(E), (6), 78 Stat. 565, 571–72 (codified as amended at 15 U.S.C. § 78o(b)(4)(E), (6)).

18. 15 U.S.C. § 78o(b)(4)(E).

19. *Id.* § 78o(b)(6). This section imposes the supervisory obligation through a cross-reference to section 15(b)(4)(E).

20. 15 U.S.C. § 78o(b)(4)(E)(i).

“without reasonable cause to believe” that the supervised person was not complying with these procedures and system.²¹ This language means that the firm and its supervisors have a statutory defense if the firm has well-drafted supervisory procedures for ensuring that the firm and all its employees comply with securities laws and regulations, as well as a system, that is, the resources and responsible people, to implement these procedures. Moreover, the firm and its supervisors have to demonstrate that they actually fulfilled their responsibilities under these procedures and system (i.e., that the system was properly functioning and not just for show).

This availability of the statutory defense to a charge of failure to supervise led to the growth of compliance, since broker-dealers would have a real interest in having a firm function—compliance—that would be responsible for drafting the supervisory procedures and assisting the firm and its supervisors in the implementation of the supervisory system. Moreover, compliance officers would ensure that the last prong of the statutory defense—that the procedures and the system were being followed in practice—was satisfied. Firms would accomplish this by having compliance officers monitor employees for legal compliance and follow up on any problem or potential problem (known in the trade as a “red flag”)²² that surfaced in a firm, which could suggest a legal violation and thus potentially a supervisory one. In sum, a firm and its supervisors can take advantage of the statutory defense by having a compliance department, or at least compliance officers, devoted to creating a well-functioning supervisory system for them to follow. The origin of compliance is, therefore, in the avoidance of supervisory liability.

SRO supervisory requirements similarly spurred the growth of compliance in firms, although by imposing a direct supervisory obligation on firms rather than indirectly through a defense to liability. The Exchange Act requires SROs to ensure that their members comply with federal securities laws and regulations, as well as with their own rules, and to have rules designed to “prevent fraudulent and manipulative acts and practices, [and] to promote just and equitable principles of trade.”²³ FINRA’s requirements of supervision are extremely detailed. FINRA requires each of its members to have “a system to supervise the activities of each registered

21. *Id.* § 78o(b)(4)(E)(ii).

22. A “red flag” is an unusual event or practice that could be a sign of a securities violation and, therefore, that must be monitored or investigated. *See, e.g.*, Gutfreund, Exchange Act Release No. 31,554, 1992 WL 362753, at *12 (Dec. 3, 1992) [hereinafter Gutfreund] (red flags are “‘suggestions’ of irregularity”).

23. *See* 15 U.S.C. § 78o-3(b)(2), (6) (for securities associations); *id.* § 78f(b)(1), (5) (for exchanges). The SEC reviews the rules in connection with the registration of an association or an exchange, as well as ongoing proposed rule changes or ones initiated by the SEC. *See id.* § 78s(a)–(c).

representative, registered principal,²⁴ and other associated person that is reasonably designed to achieve compliance” with securities laws and regulations and FINRA rules.²⁵ Among other things, the system requires a broker-dealer to have written procedures for the supervision of each of its securities businesses and associated persons (written supervisory procedures or WSPs), to designate supervisors for each regulated business, to have annual compliance reviews for each registered representative and principal, to have internal inspections of all offices, to have a principal review of the transactions and correspondence with the public of registered representatives relating to their securities business, and to investigate the character and qualifications of any associated person.²⁶ Since SRO rules govern each securities business activity and dictate how it is to be conducted in accordance with the law, nearly every FINRA rule has supervisory and, therefore, compliance implications.²⁷ FINRA rules grow or are modified each year as firms develop new businesses and products and as new legal obligations are imposed upon them.²⁸ A broker-dealer must have a division or group of employees—in other words, compliance—who can keep track of all of the legal and regulatory duties of the firm and associated

24. “Principals” are associated persons “who are actively engaged in the management of the member’s investment banking or securities business, including supervision, solicitation, conduct of business or the training of persons associated with a member for any of these functions are designated as principals.” See *NASD Rules*, FINRA, http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=605&record_id=607 (last visited Nov. 17, 2013) [hereinafter *NASD Rules*] (NASD Rule 1021(b)). As a result of the consolidation of the NASD and the regulatory arm of the NYSE into FINRA, a new FINRA rulebook combining the rules of each of these SROs is being prepared and implemented. See FINRA, *FINRA MANUAL: OFFICIAL PUBLICATION OF THE FINANCIAL INDUSTRY REGULATORY AUTHORITY* (2011) [hereinafter *FINRA MANUAL*]. As a result, currently FINRA rules include some NASD rules, some NYSE rules (which apply only to broker-dealers formerly regulated by the NYSE), and the new FINRA rules (the latter apply to all broker-dealers). See *id.* at 21–111 (providing comprehensive conversion tables between the NASD, NYSE, and FINRA Rules). Associated persons who are not principals are generally “representatives,” a term defined to mean

[p]ersons associated with a member, including assistant officers other than principals, who are engaged in the investment banking or securities business for the member including the functions of supervision, solicitation or conduct of business in securities or who are engaged in the training of persons associated with a member for any of these functions are designated as representatives.

NASD Rules, *supra* note 24 (NASD Rule 1031(b)).

25. See *NASD Rules*, *supra* note 24 (NASD Rule 3010(a)).

26. See *id.* (NASD Rule 3010(a)–(e)).

27. See, e.g., FINRA, *Deferred Variable Annuities*, Reg. Notice No. 07-53, at 7 (Nov. 2007), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p037421.pdf> (discussing supervision involved with new rule on the sale or exchange of variable annuities).

28. See, e.g., FINRA, *Customer Assets*, Reg. Notice No. 09-64 (Nov. 2009), available at <https://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p120372.pdf> (discussing enhanced supervision in light of, among other things, cases involving misappropriation of customer assets).

persons and who can help the firm's employees satisfy their obligations, and the supervisors their supervisory duties, through guidance, monitoring, and follow-up.

Moreover, NASD Rule 3012 requires that a firm have one or more principals who set up supervisory controls to test its supervisory system on a yearly basis in order to assess its compliance effectiveness and to identify the need for additional WSPs.²⁹ Under this rule, the responsible principal or principals establish the controls, conduct the testing, create additional WSPs to respond to weaknesses revealed by the testing, and report annually to a broker-dealer's senior management about the results.³⁰ The controls must cover (i) customer account activity conducted by branch office managers and other supervisors; (ii) customer account activity, such as the transmittal of funds or securities, address changes, and changes of investment objectives; and (iii) heightened supervision of certain "producing managers" who generate a significant portion of the revenue of a particular business unit.³¹ This kind of supervisory control system and related testing requires compliance specialists who understand supervisory and compliance systems and potential weaknesses in them and who follow industry developments with respect to their improvement. In addition, FINRA Rule 3130 (former NASD Rule 3013) requires a firm to appoint at least one chief compliance officer (CCO).³² Under this rule, a firm's chief executive officer (CEO) must also certify annually that there are "in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with" SRO rules and federal securities laws and regulations, and FINRA Rule 3130 requires that the CEO has had "one or more meetings" with the CCO in the preceding twelve months to discuss the processes.³³ This latter rule is both a regulatory acknowledgment of the importance of compliance and an effort to increase its importance and visibility in the management of broker-dealers. The CCO became the standard bearer of compliance in the managerial ranks of the firm.

29. See *NASD Rules*, *supra* note 24 (NASD Rule 3012(a)(1)). The initial spark for this rule was a notable failure of supervision where, undetected, a broker misappropriated over \$100 million in customer money for over fifteen years. See Self-Regulatory Organizations, Exchange Act Release No. 49,883, 2004 WL 1574002 (June 17, 2004), at *1 (recounting SG Cowen Sec. Corp., Exchange Act Release No. 48,335, 2003 WL 21946839 (Aug. 14, 2003)).

30. See *NASD Rules*, *supra* note 24 (NASD Rule 3012(a)(1)).

31. See *id.* (NASD Rule 3012(a)(2)).

32. See FINRA MANUAL, *supra* note 24, at 5111 (FINRA Rule 3130(a)); NASD, Notice to Members No. 04-79, at 974 (Nov. 2004), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p011955.pdf> ("NASD Rule 3013 is intended to bolster attention to members' compliance programs by requiring substantial and purposeful interaction between business and compliance officers throughout the firm.").

33. See FINRA MANUAL, *supra* note 24, at 5111 (FINRA Rule 3130(b)). The rule also provides a "model" certification for the CEO. See *id.* at 5111-12 (FINRA Rule 3130(c)).

In their separate ways, therefore, the Exchange Act requirements and SRO rules helped transform compliance into a specialized function within broker-dealers. In the early days of compliance, firm supervisors, aided by in-house lawyers and outside counsel, ensured that their firm and employees complied with the securities laws and regulations, as well as SRO rules and standards.³⁴ This model is still found in small broker-dealers, which operate with fewer resources than do large firms and where, for cost reasons, firm supervisors and other employees often wear multiple hats, including that of the CCO.³⁵ However, compliance has become an increasingly specialized occupation in larger firms, as the SEC and the SROs pushed them to have a compliance function that reflects their size and activities.³⁶ The increase in the number and complexity of financial activities of larger firms and the accompanying growth in laws and regulations relating to them mean that firm supervisors can no longer stay current with all of the legal, regulatory, and SRO responsibilities of their firm and associated persons.³⁷ They thus have to create and then rely upon a specialized department within the firm, compliance, whose officers can devote most of their time and efforts to the compliance tasks.

As for the tasks of the typical compliance officer, first and foremost, he or she provides advice, on a daily basis, to brokers and their supervisors on the compliance requirements for business activities.³⁸ A major, and indeed monumental, job of compliance officers is also to produce, and to keep current, the WSPs.³⁹ To accomplish this task, compliance officers must work closely with business employees to understand a particular business activity, for the WSPs dictate how firm employees should conduct the firm so as to comply with laws and regulations and how the activity should be supervised and monitored. In many ways, then, the typical WSP is a step-by-step guide to the activity (e.g., how a broker should conduct a sale, how a firm can do advertising, and how must a trade be processed). Compliance officers must also refine existing WSPs in response to problems or gaps in them revealed by the firm's experience, by the testing mandated by NASD

34. See generally SIA, WHITE PAPER ON THE ROLE OF COMPLIANCE, *supra* note 5, at 1.

35. See *id.* at 2–3 (discussing different compliance needs and structure of small firms). Smaller firms may also “outsource” some of their compliance tasks. *Id.* at 2 n.10.

36. See, e.g., Prudential Sec., Inc., Exchange Act Release No. 33,082, 1993 WL 430273, at *27 (Oct. 21, 1993) (requiring firm to have a compliance function to reflect its business).

37. See generally SEC. INDUS. & FIN. MKTS. ASS'N, THE EVOLVING ROLE OF COMPLIANCE 18 (2013) [hereinafter SIFMA, THE EVOLVING ROLE OF COMPLIANCE], available at http://www.wilmerhale.com/uploadedFiles/WilmerHale_Shared_Content/Files/PDFs/SIFMA-evolving-role-of-compliance-2013.pdf (discussing different compliance models). An early writer on financial firm compliance observed that it took shape as a specialized activity in the early 1960s. See Vass, *supra* note 9, at 54.

38. See SIA, WHITE PAPER ON THE ROLE OF COMPLIANCE, *supra* note 5, at 3; see also Vass, *supra* note 9, at 56 (referring to compliance, not pejoratively, as a “dumping ground” for firm issues) (internal quotation marks omitted).

39. See SIA, WHITE PAPER ON THE ROLE OF COMPLIANCE, *supra* note 5, at 4.

Rule 3012, or as a result of issues in them raised by FINRA or the SEC because of their inspection of a firm or because of the regulator's concern over industry-wide matters.⁴⁰ Since new laws and regulations appear constantly, the production and refinement of WSPs are never-ending tasks.

Compliance officers monitor the activities of brokers, often through the production and review of reports on transactions, to determine whether the procedures are in fact being followed.⁴¹ Today, compliance monitoring is aided by technology, which has greatly automated the reporting and review process.⁴² Compliance officers identify, and then follow up on, compliance problems or "red flags." Compliance officers are responsible, through their surveillance, for finding out when the WSPs are not being followed, which may be due to anything from an innocent mistake, to purposeful, but not harmful, noncompliance, to outright fraud. Compliance officers also detect problems through the routine internal inspections of offices and branches that are part of the supervisory system.⁴³ Moreover, they are usually the firm personnel who assist SROs, the SEC, and other regulators in regulatory examinations of their firms, and as a result they may detect problems, or at least regulatory concerns, through their interaction with the examiners.⁴⁴ Here, the work of compliance touches on the sensitive subject of enforcement of the securities and other laws and potential reporting of illegality to FINRA and the SEC. Although compliance officers may identify problems from their monitoring and inspections and assist in the conduct of investigations, the determination as to what to do about the violations generally belongs to firm supervisors.⁴⁵

It is worthwhile to raise here an important issue about the relationship between supervision and compliance that has not been definitively resolved. Supervision refers to the power of one person over another in a firm's chain of command, which includes, as discussed above, the obligation to ensure

40. *See id.*

41. *See id.* at 4–5. This is often referred to as compliance's "control," as opposed to "advisory," function. *See* SIFMA, THE EVOLVING ROLE OF COMPLIANCE, *supra* note 37, at 4. The most significant monitoring report is the "exception" report, which lists transactions that are outside certain parameters specified by the WSPs or that are otherwise flagged as suspicious, such as excessive trading or inappropriate concentration of certain products in customer accounts. *See* Vass, *supra* note 9, at 12 (discussing exception report).

42. For an excellent discussion of problems inherent in the use of technology in compliance, see Kenneth A. Bamberger, *Technologies of Compliance: Risk and Regulation in a Digital Age*, 88 TEX. L. REV. 669 (2010).

43. *See* NASD Rules, *supra* note 24 (NASD Rule 3010(c)); *see also* SIA, WHITE PAPER ON THE ROLE OF COMPLIANCE, *supra* note 5, at 5; SIFMA, THE EVOLVING ROLE OF COMPLIANCE, *supra* note 37, at 24–25.

44. *See also* SIA, WHITE PAPER ON THE ROLE OF COMPLIANCE, *supra* note 5, at 6; SIFMA, THE EVOLVING ROLE OF COMPLIANCE, *supra* note 37, at 26. A broker-dealer is subject to examination both by the SEC and FINRA, on a regular basis, as well as "for cause" (i.e., as a result of a complaint) or because of an overall investigation into brokerage practices. For a general discussion of this subject, see POSER & FANTO, *supra* note 6.

45. *See* SIFMA, THE EVOLVING ROLE OF COMPLIANCE, *supra* note 37, at 9–10.

that the supervised employee complies with securities laws and regulations.⁴⁶ It is often typified by the power of the supervisor to control the actions of, and ultimately to dismiss, an employee.⁴⁷ Compliance in a broker-dealer is not, without more, part of the supervisory structure, and a compliance officer is not, again without more, a supervisor. Rather, as explained above, compliance makes effective supervision possible. Compliance officers are not themselves supervisors insofar as they do not tell employees what to do or make disciplinary decisions when a violation is found—those actions are for the supervisors, and investigations are generally for legal officers. However, the SEC has held that, once a compliance or legal officer has a sufficient position of influence within a firm, he or she may have the responsibility, with other supervisors, for taking appropriate action in response to misconduct.⁴⁸ This action could include, in extreme circumstances such as when the main supervisors do not adequately respond to the misconduct, escalating the matter to the board of directors, resigning, or reporting the problem to regulatory authorities.⁴⁹ Since there has been a notable recent instance where a compliance officer was alleged to be a supervisor,⁵⁰ it has been recommended that compliance

46. See SIA, WHITE PAPER ON THE ROLE OF COMPLIANCE, *supra* note 5, at 10.

47. See Huff, Exchange Act Release No. 29,017, 1991 WL 296561, at *9 (Mar. 28, 1991). In a seminal SEC decision on this subject, *Gutfreund*, the SEC made the following observation in the context of discussing the supervisory responsibilities of legal and compliance officers, which offers a broader view than the control standard:

Employees of brokerage firms who have legal or compliance responsibilities do not become “supervisors” for purposes of Sections 15(b)(4)(E) and 15(b)(6) solely because they occupy those positions. Rather, determining if a particular person is a “supervisor” depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.

See *Gutfreund*, *supra* note 22, at *15 (emphasis added).

48. See *Gutfreund*, *supra* note 22, at *14.

49. See *id.* at *16. Arguably, the position taken by the SEC in the *Urban* case discussed below is broader than the two traditional theories of “control” and “affect,” since it finds supervisory liability when a person, such as a compliance officer, has “authority” in the firm, i.e., is listened to. See *Urban*, Initial Decision Release No. 402, 2010 WL 3500928, at *38 (Sept. 8, 2010) [hereinafter *Urban*].

50. *Urban*, *supra* note 49. *Urban*, who was a general counsel and also the CCO of a broker-dealer, attempted to take action against a rogue broker, who engaged in numerous legal violations, including unauthorized trading in client accounts and doing trades for a stock manipulator. *Id.* at *1, *13. *Urban* urged that the broker be dismissed, but he was overruled by the head of retail sales who agreed to supervise him personally. *Id.* at *21. The broker ultimately left the firm in the wake of numerous customer problems that resulted in a significant financial outlay by the broker-dealer. *Id.* at *25. *Urban* was charged with a supervisory violation. *Id.* at *38. The administrative law judge ruled that he was in fact a supervisor, but that he had fulfilled his supervisory responsibilities. *Id.* at *44–48. At the urging of the Enforcement Division, the SEC declined to affirm the judge’s ruling, stating, among other things, that it needed to consider whether it was enough for *Urban* to report problems to the supervisor of the broker or whether he should have escalated the matter to the firm’s chief executive officer and its board of directors. See *Urban*,

officers ensure that there is clear reporting structure in their firm, which shows that they are outside the supervisory structure.⁵¹

Furthermore, compliance officers serve as educators within the broker-dealer. Brokers have a continuing education obligation,⁵² and every broker must certify annually that he or she is in compliance with applicable laws and regulations.⁵³ Compliance officers are generally responsible for obtaining this certification (or for monitoring the technology permitting it), and they must provide, or arrange for the provision of, the necessary continuing education.⁵⁴ They are also involved in workforce training when new products or a new business line are being introduced, which requires education for brokers about how to sell the products or do the new business in compliance with the law.⁵⁵ Compliance officers also conduct training in professional and ethical standards as well as produce and administer a code of ethical conduct for the firm.⁵⁶ In this role, they may be asked to provide advice on ethical issues, as well as on matters that fall within the grey areas of the law.

The position of compliance officer in a broker-dealer is indeed diverse, often entailing such varied roles as advisor to employees involved in the securities business, transcriber of WSPs, monitor and investigator of problems, and ethical counselor. It is no wonder that this position has assumed a growing importance in firms, a subject to which I shall now turn.

Exchange Act Release No. 63,456, 2010 WL 5092728 (Dec. 7, 2010) (order denying motion for summary affirmance). Eventually, the SEC dismissed the proceedings because, with three members recusing themselves, the other two split on the decision. *See* Urban, Exchange Act Release No. 66,259, Investment Advisers Act Release No. 3366, 2012 WL 1024025 (Jan 26, 2012) (order dismissing proceeding). The case raised concern among practitioners that compliance officers were being inappropriately pulled into the supervisory structure of a firm. *See, e.g.*, David C. Prince, *NSCP Files Amicus Brief with SEC in Theodore W. Urban Case*, NSCP CURRENTS, Nov.–Dec. 2010, at 1, available at <http://www.netacn.com/documents/nov-dec-2010.pdf> (discussing position of the National Society of Compliance Professionals on this case).

51. *See* SIFMA, THE EVOLVING ROLE OF COMPLIANCE, *supra* note 37, at 17.

52. For a discussion of the continuing education obligations of broker-dealers and their registered representatives, see POSER & FANTO, *supra* note 6, § 6-56.10 to 6-56.12. These requirements are set out in FINRA Rule 1250. Generally, a broker has an obligation to fulfill a continuing education requirement every three years. *See* FINRA MANUAL, *supra* note 24, at 3115–20.

53. *See* NASD Rules, *supra* note 24 (NASD Rule 3010(a)(7)).

54. *See* SIA, WHITE PAPER ON THE ROLE OF COMPLIANCE, *supra* note 5, at 4.

55. *See id.* at 7.

56. *See id.*; SIFMA, THE EVOLVING ROLE OF COMPLIANCE, *supra* note 37, at 27–28. In addition, compliance officers have many specialized functions too numerous to discuss here: for example, they oversee the screening process and background checks for employees, as well as their licensing and qualifications; they establish and oversee anti-money laundering and Foreign Corrupt Practices Act programs; they establish control programs for the safeguarding of customer nonpublic personal information; and they oversee procedures designed to prevent insider trading and other conflicts of interest. *See generally id.* at 24–26.

II. THE GROWING IMPORTANCE OF COMPLIANCE

Compliance officers are thus in every broker-dealer, which now number approximately 4200 firms.⁵⁷ Since under FINRA rules every firm must have a CCO,⁵⁸ the number of brokerage employees engaged primarily in compliance is, at a minimum, equal to the number of firms. Larger firms are likely to have more compliance officers because their businesses are diverse and complex and thus demand a more developed compliance function.⁵⁹ Many of those who have the position of compliance officer or CCO in smaller firms have other jobs and do not devote themselves fulltime to compliance.⁶⁰ Compliance officers work in all kinds of organizational structures, depending upon the size and businesses of a firm.⁶¹ In large broker-dealers, they would generally be in a separate department or division under the CCO and thus in a separate reporting line from brokers. Although there is not extensive information available about compliance compensation,⁶² the data shows that it is less than compensation for bankers and brokers because it is not based directly on business results.⁶³ However, the gap between compliance and business personnel has diminished as compensation for compliance officers has increased in recent years.⁶⁴

57. According to FINRA statistics, which are the most recent as of October 2013, there are 4195 member firms, with 162,808 branch offices and 634,955 registered representatives. See *FINRA Statistics*, FINRA, <http://www.finra.org/Newsroom/Statistics/> (last updated July 12, 2013). The firms fall into four rough categories: (i) approximately 200 large firms, which historically were members of the New York Stock Exchange, which have most of the customer assets and most of the industry's revenue and which are often in large financial groups; (ii) mid-sized, full-line firms, which are generally regional; (iii) discount brokerage firms; and (iv) smaller firms, sometimes operating with only few brokers. See SIFMA, *FACT BOOK 2009*, at 43 (2009) (discussing the kinds of broker-dealers).

58. See *supra* note 32 and accompanying text.

59. For a description of compliance at Goldman Sachs, see *Our Divisions: Global Compliance*, GOLDMAN SACHS, <http://www.goldmansachs.com/careers/why-goldman-sachs/our-divisions/global-compliance/> (last visited Nov. 17, 2013).

60. Cf. NAT'L REGULATORY SERVS., *NRS COMPLIANCE COMPENSATION STUDY 2011*, at 5 (2011) [hereinafter NAT'L REGULATORY SERVS.], available at http://www.nrs-inc.com/Global/White%20Papers/NRS%20Compliance%20Compensation%20Study%202011_web.pdf (reporting that even CCOs in major firms spend only half of their time on compliance).

61. See generally SIFMA, *THE EVOLVING ROLE OF COMPLIANCE*, *supra* note 37, at 17–18 (discussing the various compliance structures used).

62. See generally NAT'L REGULATORY SERVS., *supra* note 60, at 5 (providing general survey data on compliance compensation); SOC'Y OF CORP. COMPLIANCE & ETHICS, *2012 CROSS INDUSTRY CHIEF COMPLIANCE OFFICERS SALARY SURVEY 19* (2012) (indicating average compensation for CCOs in financial services to be approximately \$165,000); see also *Occupational Employment Statistics*, U.S. BUREAU LAB. STAT., <http://www.bls.gov/oes/current/oes131041.htm> (reporting the mean annual wage of compliance officers in other financial services as \$64,960).

63. INST. OF INT'L FIN. IN COLLABORATION WITH OLIVER WYMAN, *COMPENSATION REFORM IN WHOLESALE BANKING 2010: PROGRESS IN IMPLEMENTING GLOBAL STANDARDS 22–23* (2010), available at <http://www.iif.com/download.php?id=lcQmuRRwWEM=>.

64. *Id.* (discussing the narrowing gap between compensation of business employees and those in control functions). Compliance officer compensation has recently stabilized. See NAT'L

Compliance gained in importance as a result of the financial crisis. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), with its accompanying SEC regulations, has resulted in more work for compliance because compliance officers have to translate the new laws and regulations into WSPs with accompanying monitoring, reporting, and inspections.⁶⁵ In addition, after the crisis, regulators and SROs have increased their oversight of financial firms and their enforcement of the laws, rules, and standards, which increases the work of compliance officers. Both the SEC and FINRA revamped their examinations of broker-dealers with, among other things, the involvement of more specialist examiners, the sharing of information among divisions (including the enforcement division), and more examinations targeting firms with the highest risks.⁶⁶ The SEC beefed up its enforcement function by forming prosecutorial groups focusing on particular kinds of financial institutions and specific abuses.⁶⁷ This examination and enforcement activity demands the attention of the compliance officer, who generally is the point person for the firm in regulatory examinations and who assists the firm's legal officers in responding to enforcement inquiries.

Congress in Dodd-Frank and the SEC in its regulations also use the existing model of broker-dealer compliance for previously unregulated financial participants. For instance, a significant part of the legislation involved the regulation of the swap markets and their major participants.⁶⁸

REGULATORY SERVS., *supra* note 60, at 2 (noting that compensation for compliance professionals has stagnated since 2008, despite new regulatory demands).

65. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, 124 Stat. 1376 (2010).

66. The requirement to enhance examinations was primarily motivated by the SEC's failure to detect the Bernard Madoff scandal, which was revealed when his Ponzi scheme collapsed during the crisis. *See* POSER & FANTO, *supra* note 6, § 7-60 to 7-64. The SEC's enhancement of examinations was mandated by Congress in Dodd-Frank section 929U, which, among other things, added a new section 4E of the Exchange Act. *See* Dodd-Frank Act sec. 4E, § 929U, 124 Stat. at 1867-68 (codified as amended at 15 U.S.C. § 78d-5 (2012)). This provision required specialized examiners for the SEC's Division of Trading and Markets, which oversees broker-dealers. *Id.* On the SEC's risk-based examination system, see SEC, FISCAL YEAR 2012 AGENCY FINANCIAL REPORT 3 (2012) [hereinafter SEC FISCAL YEAR 2012 REPORT], available at <http://www.sec.gov/about/separ/secafr2012.pdf>. On FINRA's enhancement to its own examinations in reaction to the scandal, see FINRA SPECIAL REVIEW COMM., REPORT OF THE 2009 SPECIAL REVIEW COMMITTEE ON FINRA'S EXAMINATION PROGRAM IN LIGHT OF THE STANFORD AND MADOFF SCHEMES 6-8 (2009), available at <http://www.finra.org/web/groups/corporate/@corp/documents/corporate/p120078.pdf>.

67. *See, e.g.*, Robert S. Khuzami, Dir., Div. of Enforcement, SEC, Remarks at News Conference Announcing Enforcement Cooperation Initiative and New Senior Leaders (Jan. 13, 2010), available at <http://www.sec.gov/news/speech/2010/spch011310rsk.htm> (introducing the directors of the five new National Specialized Units (Asset Management, Market Abuse, Structured and New Products, Foreign Corrupt Practices Act, and Municipal Securities and Public Pension)).

68. *See* Dodd-Frank Act tit. 7, §§ 721-74, 124 Stat. 1658-1802. Swap regulation was divided between the Commodity Futures Trading Commission and the SEC, depending upon the nature of the underlying asset that was the subject of the swap.

Swap dealers are now regulated in a manner that, understandably enough, parallels, and is modeled on, that of broker-dealers.⁶⁹ As a result, a swap dealer must have a supervisory structure and record-keeping, which naturally demand a compliance function.⁷⁰ Dodd-Frank has thus ushered in a whole new era for compliance, albeit particularly in financial firms like investment advisers and swap dealers.

That compliance officers now have a significant place in broker-dealers means that ultimately the regulatory burden emanating from the crisis will fall on them. As a result of the financial crisis, as discussed above, legislators, regulators, and FINRA officials have shown a renewed zeal for law creation and enforcement,⁷¹ but their efforts will eventually wane. Legislators become distracted with other, more pressing concerns. The SEC has limited resources in this time of scarcity, and its budget is neither growing nor likely to grow significantly in the future.⁷² FINRA has improved its oversight over broker-dealers.⁷³ Yet while the SRO is closer to these firms, its examiners and enforcement staff are not in them on a day-to-day basis.

Compliance officers, by contrast, are in the firms, and, as discussed above, they are specifically charged with legal, professional, and ethical compliance.⁷⁴ Most importantly, they actually see what is occurring in the firms. They are thus well situated to alert supervisors and senior executives to growing problems, such as the securitization of subprime loans, which may infiltrate the financial industry and gradually grow into a dreaded and resented financial crisis. Being involved with compliance and assisting in the supervision of every broker and securities activity in a broker-dealer, a compliance officer is well positioned to identify such problems perhaps before they are transformed into larger, potentially systemic issues. Furthermore, given the sheer number of new laws and regulations imposed upon broker-dealers as a result of the most recent financial crisis, the brokerage industry could not survive without compliance officers. The compliance officer today in a broker-dealer does not generally have to worry about remaining employed, but he or she is likely to be overwhelmed with work.⁷⁵ A question posed by the symposium is whether the legal academy can help him or her with the burden.

69. See POSER & FANTO, *supra* note 6, § 5-40 to 5-44.1.

70. Indeed, new section 15F(k) of the Exchange Act dealing with security-based swap dealer regulation mandates that such a dealer have a CCO to implement compliance in the dealer. See 15 U.S.C. § 78o-10(k).

71. See *supra* notes 66–67.

72. For a description of the SEC's lack of adequate financial resources for its mission in recent years, see SEC, STRATEGIC PLAN: FISCAL YEARS 2010–2015, at 6–7 (2010), available at <http://www.sec.gov/about/secstratplan1015f.pdf>.

73. See SEC FISCAL YEAR 2012 REPORT, *supra* note 66, at 48.

74. See *supra* text accompanying notes 38–56.

75. See SIFMA, THE EVOLVING ROLE OF COMPLIANCE, *supra* note 37, at 18–19.

III. COMPLIANCE AND THE LEGAL ACADEMY

There has been little work on financial compliance in the legal academy. It is not that scholars have ignored compliance entirely. Indeed, there have been scholarly articles written on compliance in public corporations, including studies with the approach of New Governance—an academic movement encouraging regulators and the regulated to produce more effective regulation by cooperating in rule-making.⁷⁶ Many New Governance insights can be brought to the financial area and could be applied to the role of compliance in the development of cooperative regulation. In addition, there has been considerable academic work about how the emphasis on enforcement and prosecution adversely affects regulation, including the regulation of financial institutions.⁷⁷ This is relevant to financial firm compliance insofar as compliance officers can be enlisted in the SEC's and FINRA's enforcement efforts, as well as prosecution by the U.S. Department of Justice.⁷⁸ Despite these fruitful areas of scholarly activity with their occasional references to financial compliance, there has been little sustained attention to this subject.

Given the nature of the legal academy and its relationship to legal practice, this lack of attention is not surprising. Compliance is part of the day-to-day operations of broker-dealers and is a technical feature of broker-dealer practice. Law professors who specialize in securities law spend most of their time on issues related to capital raising and public company disclosure and considerably less time on market structure and particularly on market intermediaries.⁷⁹ Their orientation may reflect the traditional desired destination of the students of elite schools, the large corporate law firms that focus primarily upon financing and transactions,⁸⁰ not on the

76. See generally Orly Lobel, *New Governance as Regulatory Governance*, in THE OXFORD HANDBOOK OF GOVERNANCE 65 (David Levi-Faur ed., 2012).

77. See generally Miriam Baer, *Organizational Liability and the Tension Between Corporate and Criminal Law*, 19 J.L. & POL'Y 1 (2010) (arguing that the emphasis on prosecutorial discretion as a means of rehabilitating corporate wrongdoers creates the potential for waste and abuse and detracts from the need for corporate and securities laws that decrease the underlying risks of criminal misconduct); John Hasnas, *Managing the Risks of Legal Compliance: Conflicting Demands of Law and Ethics*, 39 LOY. U. CHI. L.J. 507, 517 (2008) (“[T]he use of extrinsic punishment and rewards by the command-and-control approach undermines the intrinsic motivation necessary to the self-regulatory approach.”).

78. See SIFMA, THE EVOLVING ROLE OF COMPLIANCE, *supra* note 37, at 35 (discussing regulators’ “deputizing” compliance officers as their agents).

79. This is exemplified by the coverage in securities law textbooks. For example, one prominent book spends about 450 pages on capital raising and about 140 pages on securities markets and broker-dealers. See JOHN C. COFFEE, JR. & HILLARY A. SALE, *SECURITIES REGULATION* (12th ed. 2012).

80. On the destination of elite school graduates, see LAWRENCE M. FRIEDMAN, *LAW IN AMERICA: A SHORT HISTORY* 167 (2002). See also Ralph Nader, *Corporate Law Firms and the Perversion of Justice: What Public Interest Lawyers Can Do About It*, 1 WASH. U. J.L. & POL'Y 53 (1999).

operations of intermediaries like broker-dealers or securities exchanges.⁸¹ Moreover, even scholars who occasionally study intermediaries are likely to be interested in legal issues like fiduciary duties that are more academic and jurisprudential, rather than in the day-to-day operations of compliance departments.⁸² The relative lack of attention in the legal academy to compliance may also reflect that compliance as a field was not traditionally the exclusive domain of lawyers, but included operations and back office personnel.⁸³ Finally, my personal impression is that few legal academics today come to law teaching from as specialized a practice background as financial firm compliance. They are thus not likely to have the experience to write about it.

Things may now be changing. There is an employment reason for this transformation because there is a perception, whether it is right or wrong, that financial firm compliance offers job opportunities for students in this difficult employment environment. This may be true since, given the sheer number of regulations that compliance must handle, it is useful for compliance officers to have legal training. Indeed, law schools are now entering into the process of training students for compliance positions⁸⁴ and providing externships with financial regulators or within compliance departments of financial firms.⁸⁵ Moreover, since law schools are feeling the pressure to prepare their students for the practicing world that awaits them, they might provide a transition course in compliance for students entering the field.⁸⁶ Thus, this perceived need to teach about compliance may spur more scholarly focus on the subject, and it was precisely to stimulate this scholarly work that the symposium was organized.

This new academic focus on compliance may be beneficial. As has been explained above, compliance officers occupy a difficult, but important, position in financial firms, translating the laws and regulations into actual firm practice and serving as an intermediary between the regulators and the regulated.⁸⁷ It would be valuable if academics could reflect upon this role

81. See Sida Liu, *The Legal Profession as a Social Process: A Theory on Lawyers and Globalization*, 38 L. & SOC. INQUIRY 670, 681 (2013) (discussing what elite corporate firms do).

82. See, e.g., Arthur Laby, *Selling Advice and Creating Expectations: Why Brokers Should Be Fiduciaries*, 87 WASH. L. REV. 707 (2012). Professor Laby, a former SEC staff member, is one of the few professors who understands compliance, but even his work centers more on properly legal topics like fiduciary duty.

83. But see Vass, *supra* note 9, at 55 (“In the earlier years, persons who served as internal general counsels were often also designated as Compliance officers.”).

84. The Regulatory Compliance Association offers online education in asset management compliance in conjunction with law schools. See *Law & Masters Degree*, REG. COMPLIANCE ASS’N, <https://www.rcaonline.org/law-masters-degree/> (last visited Nov. 17, 2013).

85. Our own law school has for a long time offered externships with FINRA, the SEC, and financial firms.

86. The author offers such a course at Brooklyn Law School together with compliance officers and other specialists in the compliance field. It is entitled “An Introduction to Compliance and Risk Management in Financial Institutions.”

87. See *supra* Part II.

with all the imagination (and without the concern about not offending their clients) that they typically bring to the task. This attention could of course have unpredictable results because it is certainly possible that they would criticize compliance and even argue that it be reduced in firms. To give an example, Professor Birdthistle, who was a participant in our symposium, has co-written an article with Professor Todd Henderson of the University of Chicago.⁸⁸ In this paper, among other things, they criticize the compliance industry as part of their overall criticism of FINRA's transformation from an SRO into a quasi-governmental regulator.⁸⁹ Their implication is that compliance officers and compliance consultants, often drawn from regulators and FINRA, do not want to challenge the current regulatory status quo of FINRA's dominance since they profit from it, even if this situation is not the best for the financial industry and investors.⁹⁰

Alternatively, law professors could look critically at the current functioning of compliance, identify issues or problems in it, and suggest how compliance officers could address these issues and improve their performance. Legal academics are particularly useful in this regard, again because they are not beholden to specific clients and because they take a broad view of the subject matter, which might enable them to see trends and issues not clear to those "in the trenches." This kind of scholarly work was evident at the symposium. Professor Barbara Black, a noted securities scholar who has longstanding experience with FINRA's disciplinary proceedings through her participation on its National Adjudicatory Council, reflected upon the compliance-specific implications of FINRA sanctions, which are expressly remedial rather than punitive.⁹¹ Professor Jerry Markham raised an issue that has been the subject of considerable concern in the compliance industry throughout financial services: the safe custody of customer assets.⁹²

As he identified, the issue has surfaced in failures or scandals in different kinds of financial firms, such as broker-dealers, investment advisers, and commodities firms, where the firms inappropriately used or

88. See William A. Birdthistle & M. Todd Henderson, *Becoming a Fifth Branch*, 99 CORNELL L. REV. 1 (2013). Professor Birdthistle, who was sick on the day of the symposium, spoke by videoconference.

89. See *id.* at 44–49.

90. See *id.* at 48.

91. See Barbara Black, *Punishing Bad Brokers: Self-Regulation and FINRA Sanctions*, 8 BROOK. J. CORP. FIN. & COM. L. 23, 46 (2013).

92. This is because, perhaps starting with the *Bernard Madoff* case, there have been repeated cases of financial firms either stealing customer assets or using them improperly. The most recent case was *MF Global*, where customer assets were used essentially to prop up the firm, which was failing because of its bets on European government securities. See Report of Investigation of Louis J. Freeh, Chapter 11 Trustee of MF Global Holdings, Ltd. et al., *In re MF Global Holdings Ltd.*, No. 11-15059 (MG) (Bankr. S.D.N.Y. Apr. 4, 2013), available at http://www.mfglobalcaseinfo.com/pdf/1279_15059.pdf (discussing the scandal).

simply misappropriated customer assets.⁹³ Professor Markham provided an overview of this problem and the regulatory responses to it, which could help in the reform process as regulators decide upon the most effective approach to safeguarding customer assets. Professor Deborah DeMott examined the position of the CCO and its importance in enhancing the firm's reputation.⁹⁴

Legal scholars could also aid compliance because they often bring insights from other academic disciplines into their legal analysis. One of the most prominent academics who has often drawn insights from psychology and organizational studies is Professor Donald Langevoort, who at our symposium offered comments on other professors' papers.⁹⁵ He intriguingly raised the point that compliance's task of helping to ensure that financial firm employees comply with the law is all the more challenging because of the very nature of the business employees. He meant here physical nature, citing intriguing work on the neurological basis of financial risk-taking. In a similarly broad vein, Professor Tamar Frankel (albeit through a proxy, since she could not attend the symposium because of the weather) explored the beneficial effect of codes of conduct in changing the *culture* of regulated investment funds with respect to deterring insider trading.⁹⁶ From her typically broad perspective, which incorporates learning from ethical studies, she offered thoughts on why the codes work in this situation, which could serve as a model for other financial firms wishing to have effective codes.⁹⁷

I offered my own psychologically based reflections on compliance at the symposium. To take one case discussed above, compliance officers spend a lot of time drafting and revising WSPs and then monitoring the brokers' compliance with them.⁹⁸ Despite these detailed directions and monitoring, it is not possible for compliance officers to cover every topic and to oversee all activity in brokerage operations. Indeed, this kind of extensive direction and oversight might even have a negative effect in a field like brokerage, many of whose activities are not routine, and which benefits from the discretion and independence given to its employees.⁹⁹ If

93. See Jerry W. Markham, *Custodial Requirements for Customer Funds*, 8 BROOK. J. CORP. FIN. & COM. L. 92 (2013).

94. See Deborah A. DeMott, *The Crucial But (Potentially) Precarious Position of the Chief Compliance Officer*, 8 BROOK. J. CORP. FIN. & COM. L. 56 (2013).

95. See, e.g., Donald Langevoort, *Chasing the Greased Pig down Wall Street: A Gatekeeper's Guide to the Psychology, Culture, and Ethics of Financial Risk Taking*, 96 CORNELL L. REV. 1209 (2011).

96. See Tamar Frankel, *Self-Regulation of Insider-Trading in Mutual Funds and Advisers*, 8 BROOK. J. CORP. FIN. & COM. L. 80 (2013).

97. See *id.* at 90.

98. See *supra* text accompanying notes 41–45.

99. See Gary R. Weaver & Linda Klebe Treviño, *Compliance and Values Oriented Ethics Programs: Influences on Employees' Attitudes and Behavior*, 9 BUS. ETHICS Q. 315, 329–30 (1999) (explaining the problems with all-encompassing compliance programs).

the WSPs produce too much routine behavior and the monitoring is too heavy-handed, brokers and bankers may see the compliance procedures as *external* to their business and ultimately as a hindrance, to be complied with only formally or even “gamed.”¹⁰⁰ Compliance officers will likely succeed in catching most of the egregious violations through this kind of monitoring, but there are likely to be others that slip by them.¹⁰¹ More significantly, there may be problems that do not rise yet to the level of violations but that could do so in time or that pose professional or ethical issues, which may have an eventual, calamitous effect upon the firm if brokers continue to engage in them.

While compliance officers must continue to produce the WSPs (if only to let brokers know about their legal obligations) and to monitor for compliance, their ultimate goal has to be self- or *internal* compliance by a broker—the compliance officer would be left essentially to be an advisor on difficult issues.¹⁰² In other words, the ideal purpose of a compliance officer would be to have brokers internalize legal and regulatory policies and ethical standards so that these policies and standards come to the foreground in their decision-making and displace others, such as self-interest, which could lead to legal and ethical violations.¹⁰³ This purpose falls squarely within the educational and cultural role of compliance. Yet in order to promote this internal compliance, compliance officers would have to understand how decision-making in fact occurs in people, particularly when they have competing goals and work in cohesive groups and organizations, and what techniques might be used to encourage brokers to focus on legal and ethical standards in decision-making. This understanding

100. See Tammy L. MacLean & Michael Behnam, *The Dangers of Decoupling: The Relationship Between Compliance Programs, Legitimacy Perceptions, and Institutionalized Misconduct*, 53 ACAD. MGMT. J. 1499 (2010) (discussing how compliance programs can become divorced from the business activity of the firm, resulting in more misconduct). In other words, the employees would find a way to “disengage” the legal and ethical values from their everyday practice. See generally Albert Bandura et al., *Mechanisms of Moral Disengagement in the Exercise of Moral Agency*, 71 J. PERSONALITY & SOC. PSYCHOL. 364 (1996) (discussing the classic processes of moral disengagement: justifying detrimental action by (i) classifying it as moral, (ii) diffusing the responsibility for it, (iii) disregarding or distorting its consequences, and (iv) blaming the victims for one’s actions).

101. What I term “external” monitoring is always necessary for compliance, since it is a major way in which social values are enforced. See Bandura et al., *supra* note 100, at 372. Thus, I am not suggesting that we eliminate the detailed compliance procedures and the external monitoring.

102. I explore this notion in more depth in a paper entitled *Surveillant and Counselor: A Reorientation in Compliance for Financial Firms*, (Brooklyn Law Sch. Legal Studies Working Paper Series, Paper No. 358, 2013), available at <http://ssrn.com/abstract=2321317>.

103. Another way of saying this is to ensure that the policies and standards do not “fade.” See generally MAX H. BAZERMAN & ANN E. TENBRUNSEL, BLIND SPOTS: WHY WE FAIL TO DO WHAT’S RIGHT AND WHAT TO DO ABOUT IT 69 (2011) (discussing “ethical” fading, where ethical dimensions of a decision “fade” at the time of decision-making).

is likely to come from the disciplines of psychology, social psychology, organizational studies, and, to a lesser extent, from economics.¹⁰⁴

For a long time, management scholars have provided these kinds of insights and guidance to managers and executives, who of course are concerned with having legally and ethically compliant organizations and employees.¹⁰⁵ It seems to me that legal scholars who follow developments, or who are even trained, in the above fields could do the same for compliance officers, particularly, as noted above, since an increasing number of compliance officers have legal training and are open to discussions with law professors. This work should be attractive to securities law scholars, for they are concerned with legal policies that improve the functioning of markets and market intermediaries. Certainly, investors will actively participate in securities markets if they perceive, partly as a result of a more robust compliance, that the broker is acting on their behalf in accordance with securities law policies and SRO professional standards, and not just thinking of investors as a personal profit center.

CONCLUSION

The symposium at Brooklyn Law School, as well as the contributions in this issue, recognizes the growth and importance of compliance in financial firms. Its growth was initially spurred by the statutory and regulatory requirements of broker-dealers to have supervisory systems to address the potential supervisory liability of the firm and its managers for legal and ethical violations by its employees. As the legal, regulatory, and ethical obligations on firms and their employees have grown over the past forty years, compliance has evolved from a minor task performed by a supervisor with the assistance of outside counsel, or by back office personnel, to a developed control function in the firm. Now compliance officers, who are required in every firm, often preside over a large department and have a seat

104. I give this qualification to economics because its model of human decision-making appears not to reflect how people actually make decisions in real circumstances. For a summary of advances of economics in this regards, see Nicholas C. Barberis, *Thirty Years of Prospect Theory in Economics: A Review and Assessment*, 27 J. ECON. PERSP. 173 (2013). On the utility of the economic rational actor framework in some circumstances, see Colin F. Camerer & Ernst Fehr, *When Does “Economic Man” Dominate Social Behavior?*, 311 SCIENCE 47 (2006).

105. Many of the scholarly articles providing this guidance appear in, among other places, the Academy of Management publications. I have mentioned several of these works in the course of the last paragraphs. For other useful works, see Brian C. Gunia et al., *Contemplation and Conversation: Subtle Influences on Moral Decision Making*, 55 ACAD. MGMT. J. 13, 17, 22 (2012) (finding that conversation that raises ethical matters or figures, as opposed to conversation focusing on self-interest, leads to more ethical decisions); David M. Mayer et al., *Who Displays Ethical Leadership, and Why Does It Matter? An Examination of Antecedents and Consequences of Ethical Leadership*, 55 ACAD. MGMT. J. 151, 153–54 (2012) (discussing the importance of ethical leadership in organizations); Long Wang & J. Keith Murnighan, *On Greed*, 5 ACAD. MGMT. ANNALS 279, 301 (2011) (discussing how “calculative” self-interested mindset is triggered).

at the table of top management. With the growth of compliance has come its development as a career path, which is attractive in a tight job market. For this and for other reasons, compliance is now noticed by law schools.

I have argued in this introductory Article that the new attention to compliance could be fruitful both to legal scholars and to compliance officers. The latter occupy a key place on the front lines of financial firms between regulators and employees conducting the securities business. They are expected to help firm employees comply with legal and ethical obligations in jobs that demand considerable freedom and discretion. If compliance officers are to be successful in this goal, they need to do more than simply translate the laws and rules for employees and monitor compliance with them. They have to promote compliant conduct within the employees themselves, which is a complex advisory and educational task. The interaction between compliance officers and legal scholars, who follow developments in disciplines like social psychology and organizational research that study how to promote compliant and ethical conduct, could contribute to the future growth and success of compliance itself. Let us hope that our symposium will be one of many steps in this fruitful collaboration.